BRIEF MARKET COMMENTARY – U.S. AND CHINA TRADE NEGOTIATIONS
May 2019

Volatility spiked early last week after President Trump upended the expectation for an imminent trade agreement. After concluding that the Chinese were reneging on terms they had agreed to during earlier bargaining rounds, Trump opted to more than double tariffs on $200 billion in Chinese imports. This tariff increase to 25% from 10% took effect on Friday. The Trump administration also began the process of expanding tariffs to cover an additional $300 billion in imports, leaving almost no products from China entering the U.S. without incurring a tax. In retaliation, the Chinese government yesterday announced plans to impose tariffs ranging from 5% to 25% on 5,140 U.S. products worth about $60 billion. It said the tariffs will take effect on June 1st.

With respect to negotiation, it seems we're watching President Trump employ classic Art of the Deal tactics to carefully gain negotiating leverage. While the new 25% rate on Chinese goods went into effect at 12:01am Friday, the higher tariffs will only hit products that leave China after that time, not those already in transit.[1] That could provide some additional time to contemplate the consequences of failure and to potentially hammer out a compromise. For the last several days, three U.S. Navy guided-missile destroyers have been operating in the South China Sea, and late last week the United States seized a massive Korean coal freighter. It's unlikely these events and their timing are mere happenstance.

Despite all of this, the mutual interests of both sides demand cooperation, and the greater likelihood remains that the U.S. and China will work to avoid the economic risks of confrontation. Yet, President Trump and Chinese President Xi Jinping may have to work with each other directly to get this resolved. Trump announced yesterday that he'll meet face-to-face with Xi at the G20 summit late next month. Financial markets are trying to discount a U.S.-China trade deal that is perhaps 80% done but still a binary event. Uncertainty could linger, and things could get worse before they get better.

In terms of the potential economic impact, Strategas Research Partners estimates that the hit to U.S. GDP is likely about -0.1% point for every 2 months we go along with the higher China tariff rates, or roughly -0.6% points for a year. Strategas estimates that a little more than half of this impact is through reduced confidence and lower investment. The hit to China's GDP should be substantial as well, though there may be offsetting local stimulus and/or an unwillingness to actually report a weaker number in China.[2]

The set of scenarios, and the inherent uncertainty involved, reinforces the need for thoughtful portfolio diversification and manager selection. Because we aim to position portfolios for a range of outcomes, we aren't recommending any changes to portfolio strategy at this time. We advocate maintaining a defensive tilt—a slight overweight to cash/short-term fixed income and a slight underweight position in U.S. equities with an emphasis on quality. We continue to expect elevated market volatility as is typical of the late-cycle. Yet, the ongoing global economic expansion and prospect for central banks to stay accommodative should provide support to equities and other risk assets. The recent spike in volatility reinforces the need for a balanced approach—and the role of high-quality bonds as a source of stability and diversification of equity market risk.

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[1] *Ana Swanson and Alan Rappeport, The New York Times, "Trump Increases China Tariffs as Trade Deal Hangs in the Balance," May 9, 2019.*
[2] *Don Rismiller, Strategas Research Partners. "No Relief Yet: Trump/Xi Must Solve U.S./China," May 13, 2019.*

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